

January 5, 2004

Honorable Susan Collins  
Chairman, Committee on Governmental Affairs  
U. S. Senate  
340 Dirksen Senate Office Building  
Washington, D.C. 20510

Honorable Tom Davis  
Chairman, Committee on Government Reform  
U.S. House of Representatives  
2157 Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Collins and Chairman Davis:

In October of 2003, the U.S. General Accounting Office issued a report on the financial condition of the credit union industry, changes in the National Credit Union Administration's (NCUA) examination and supervision processes, and other issues related to NCUA and credit unions. The report, entitled "Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management," was received by NCUA on November 4, 2003. This letter constitutes the statement of actions taken on GAO's recommendations that is required within 60 days of our receipt of the report pursuant to 31 U.S.C. 720.

NCUA appreciates the professionalism shown by GAO officials throughout the preparation of their report, and we applaud the quality of their work. NCUA is gratified that GAO concludes in its report that "the credit union industry has improved since GAO's last report in 1991, and the federal share insurance fund appears financially stable." The report contains five specific recommendations for executive action by NCUA. Our response to each of those recommendations follows.

#### **Access to Underserved Areas**

**Recommendation:** Use tangible indicators, other than "potential membership" to determine whether credit unions have provided greater access to credit union services in underserved areas.

**Response:** Implementation of this recommendation would require that NCUA impose substantial expanded recordkeeping and reporting burdens on federally insured credit unions. NCUA does not believe the burdens are cost-justified. However, we will carefully consider whether there are additional ways of using existing data to determine the success of credit unions in providing greater access to service in underserved areas.

GAO's recommendation is based in part on the conclusion that both the Federal Reserve's most recent Survey of Consumer Finances (SCF) and the Home Mortgage Disclosure Act (HMDA) database are subject to the interpretation that credit unions on the average serve a slightly lower percentage of low and moderate income households than banks. However, the GAO report acknowledges potential deficiencies in this conclusion. HMDA reporting requirements in 2001, for example, did not apply to credit unions with less than \$31 million in assets. As the report notes, this excluded from the HMDA data some 3,800 small credit unions, many of which have a low income designation or other specific emphasis on serving those of limited means. The report also notes that while the SCF data indicates that credit unions serve a lower percentage of low-income households than banks, the same data indicates that credit unions serve a higher percentage of moderate-income households. This result is not surprising, considering the traditional emphasis of credit unions on serving specified occupational common bonds, which has restricted many credit unions to serving only those moderate to upper-income individuals employed within the credit union's specified field of membership.

Developments that have begun in the last few years will continue to make it more possible for credit unions to serve individuals of limited means. An increasing number of credit unions are taking advantage of recent flexibility in both NCUA and state field-of-membership rules to convert to community charters, thus allowing those credit unions to diversify by being made eligible to serve everyone in their community of operation, rather than just those employed in specified businesses or sectors. Also, 10.2% of all credit unions now have low-income designations, meaning that more than 50% of the field of membership is low income. This compares to slightly over 1% ten years ago. Credit unions are expanding into underserved areas at a record pace. Since January of 2000, federally-insured credit unions have added 965 underserved areas to their fields of membership, making over 61 million people in these areas eligible for credit union membership. These 965 credit unions had an actual membership growth rate over the period from 2000 through 2002 that was 92.8% higher than that of credit unions nationwide. All of this serves to demonstrate a clear commitment within the credit union system to continued emphasis on serving individuals of limited means, and successes in doing so.

NCUA fully intends to continue and promote its numerous initiatives that emphasize credit union involvement in reaching out to underserved members within the bounds of safety and soundness. Our Access Across America

initiative encourages credit union involvement with government and community programs, as well as faith-based organizations, to provide economic empowerment in underserved areas, and has been instrumental in bringing about the expansion into underserved areas noted above. We have significantly revised the member business lending rule to facilitate greater credit union involvement, within proper safety and soundness limitations, in meeting start-up credit and other small business credit needs that are so critical to revitalization of underserved areas. We are actively participating in the Bush Administration's "America's Home Ownership Challenge," as well as providing permanent representation and active involvement with the Neighborhood Reinvestment Corporation. With these and other initiatives in place, continuing strong efforts by credit unions to move into and effectively serve areas that are currently underserved can be expected.

As these commitments on the part of NCUA and the credit system continue, it will be important to continue to review available data, including the results of future SCF and HMDA reports. The imposition of expanded data collection requirements, however, would impose significant costs and other burdens on both NCUA and credit unions. The most meaningful data would include information on the demographics of all credit union members, not just those who use consumer loan or mortgage loan services. This is especially true in low-income and underserved areas, where the first relationship and first indicator of service is often a share or share-checking account, or the use of money transfer services, rather than a consumer or mortgage loan. Requiring this sort of data, however, would both raise issues of consumer privacy and require a retooling of membership forms and data processing systems for all insured credit unions. The many millions of dollars in cost burden, which would fall especially hard on small and mid-sized credit unions that are in many cases already struggling to exist as independent entities, is in our view clearly not justified by the available evidence. In addition, an adverse impact could be felt on the increased number of credit unions expanding their services into underserved areas if additional and costly reporting burdens are imposed as a condition of their adoption of underserved communities into their fields of membership.

While we currently do not believe that expanded data collection requirements are warranted, we have made it a high priority of our internal agency working group that is following up on each of the report's recommendations to carefully consider whether there may be additional ways of using existing data to determine the success of credit unions in providing membership and member services in underserved areas. For example, member zip code data already maintained by credit unions might be useful in determining service in underserved areas. Similarly, growth and other trends in credit unions that have recently converted to community charter, combined with information about the existence of underserved areas in their communities, may also be useful.

## **Risk-Focused Programs**

**Recommendation:** Consult with other regulators through FFIEC more consistently about risk-focused programs to learn how these regulators have dealt with past challenges.

**Response:** NCUA will continue to work with the FFIEC Agencies in developing training curriculums for staff – including training for the Subject Matter Examiners (SMEs).

To date, the Agency's in-house training has varied based on training needs in each subject area. With recognition of the extensive training needs in the areas of Information System and Technologies and Capital Markets, annual training sessions have been held for the past three years. Staff's knowledge in these areas continues to be enhanced. A training symposium on lending issues was held in October, 2003 for the lending examiners with concentration of training in the area of member business loans. Ongoing and increased emphasis on business lending training will be important as credit unions continue to serve the business credit needs of their members in a constantly evolving marketplace, and NCUA will expand its consultation and cooperation with the other FFIEC agencies in an effort to provide additional subject matter expertise in the area of small business lending.

Overall, the emphasis on more specialized training has increased. To underscore the importance of training in specialized subjects, an internal group was formed to oversee the SME program. In 2004, this group will meet at least quarterly to assess the progress made in identifying needed competencies and the training opportunities that develop those competencies.

Another NCUA staff group is reviewing and assessing programs utilized by the other FFIEC agencies for their specialized examiners. It is anticipated that this information will provide added knowledge that will improve and enhance our SME program.

Going forward, close coordination with the other Agencies will continue in an effort to identify best practices that will assist the development of staff and improve their overall expertise in subject matter areas. By having a well-trained staff in specific areas, the risk-focused examination program will be enhanced and should become a better and more efficient tool in ensuring the safety and soundness of federally-insured credit unions.

## **Overhead Transfer Rate**

**Recommendation:** Make improvements to the process for determining the overhead transfer rate (OTR) by applying the rate consistently, updating the rate

annually, completing the survey with full representation, and implementing the recommendations made by the external auditor.

**Response:** NCUA began researching improvements to the process for determining the overhead transfer rate (OTR) in November 2002. As a result of this effort, in November 2003 the NCUA Board approved a refined method for calculating the overhead transfer rate. This new method is more comprehensive in that the formula has been expanded to take into account additional factors, thus providing greater equity and accuracy in the calculation and allocation of costs. These additional factors include:

- ④ The value to the NCUSIF of the insurance-related work performed by state supervisory authorities.
- ④ The cost of NCUA resources and programs with different allocation factors from the examination and supervision program.
- ④ The distribution of insured shares between federal credit unions and federally insured state-chartered credit unions.
- ④ Operational costs charged directly to the NCUSIF.

Consistent with the GAO recommendation, the NCUA Board approved use of this new formula for setting the OTR on an annual basis. The formula provides for the recommended consistency in application of the rate and enables NCUA to set the OTR annually with the most current information. Making the formula available to the public also improves the transparency of the process.

NCUA fully implemented all of the external auditor recommendations in 2002, and the agency now has almost 18 months worth of survey results based on the revised process. For the June 2004 to June 2005 survey cycle, NCUA will be increasing the survey's sample size by 66 percent as adjustments are made for the regional realignment. This will result in a very robust sample, further ensuring statistical validity.

NCUA has also made significant strides in improving the transparency of the OTR process. The three primary credit union trade organizations were fully briefed on the proposed new method. Comments were solicited and, as appropriate, incorporated into the final version presented to the NCUA Board. The new method was presented in detail at the public NCUA Board meeting, and the publicly available Board Action Memorandum included a detailed explanation of the new method. In addition, comprehensive documentation describing the new OTR method and how it is calculated is posted on NCUA's Internet site.

Although differences of opinion have long existed and will certainly continue as to how the OTR should be approached, NCUA has received generally positive feedback on its revised OTR process and methodology, which reduced the 2003 OTR rate of 62% to 59.8% for 2004.

## **Risk-Based Pricing for Federal Share Insurance**

**Recommendation:** Research risk-based pricing for share insurance to better allocate costs to insured institutions based on the relative risk they pose to the fund.

**Response:** Risk-based pricing would require action by Congress to amend the Federal Credit Union Act, which currently requires uniform pricing with respect to the one percent deposit and any insurance premium. The mutual nature of the NCUSIF's statutory model is consistent with the ownership and profit/cost-sharing model upon which credit unions themselves are based. The current NCUSIF model has been very successful, resulting in a healthy fund and industry. Since the point of any pricing change to the NCUSIF model would be to address perceived inequities, not to improve the already sound financial condition of the fund or address any operational concerns of the insurance fund, stakeholders should have an active role in considering this issue.

Almost all of the current research and analysis regarding deposit insurance pricing relates to FDIC's exploration of changes to its statutorily mandated risk-based premium structure. In our preliminary review of the available research, the following common themes related to deposit insurance pricing reforms surfaced:

- Any risk-based pricing structure for deposit insurance would need to capture the unique systemic and concentration risks posed by large institutions, address the impact on smaller institutions, and incorporate the differing severity of losses among smaller and larger institutions to equitably allocate costs.
- Deposit insurance pricing should not be pro-cyclical as this would exacerbate problems in weak institutions and impede the financial institution industry's ability to provide credit during downturns in the business cycle, limiting their ability to help promote an economic recovery.<sup>1</sup>

Overall fund equity levels and policies regarding assessment of premiums or return of excess funds are integral to this issue. The NCUSIF has an advantage, provided by the Credit Union Membership Access Act (CUMAA), over the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) as NCUA is provided with greater flexibility in setting the NCUSIF's normal operating level (up to 1.50 percent, as compared to the FDIC's statutorily mandated level of 1.25 percent). Thus, the NCUA Board has the authority to establish an anti-cyclical fund policy by setting the normal operating level of the fund high enough to allow for the accumulation of equity in periods of strong performance, and then allow the fund to decline (though

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<sup>1</sup> Federal Reserve Board Chairman Alan Greenspan's February 2003 testimony before the Senate Committee on Banking, Housing, and Urban Affairs supports the need to avoid a pro-cyclical insurance pricing system.

not below the statutory minimum of 1.20 percent) during economic downturns before charging a premium. Equity issues still arise in regard to the method for assessing premiums and paying dividends. In recognition of the increase in risk inherent in the financial services market (increase in concentration of assets, expanded powers, competition and innovation driving new types of risk), and to ensure we avoid a pro-cyclical insurance fund policy, we annually re-evaluate the NCUSIF's normal operating level, which is currently set at 1.30 percent.

- ④ An appropriate measure of relative risk that includes the risk profile of each institution's activities, its financial resources, and the quality of its management should be established. An appropriate measure most likely would be based on each individual institution's profile while providing adequate insurance fund funding on the whole. Additionally, the method should be transparent and understandable. There is also fairly universal concern regarding subjective measures, such as use of CAMEL ratings, and the need for the method to be dynamic versus static to address innovation and emerging risks, something government regulation typically has difficulty achieving. Given the unique systemic nature of risk in financial institutions, it is important to note that a risk-based pricing system would never fully cover the associated risks for the very small probability of very large losses, as it would be prohibitively expensive.

Several researchers have questioned the consistency and subjectivity of using CAMEL ratings for risk-based pricing. In our initial response to the GAO report, we expressed a similar concern, indicating our experience has been that CAMEL ratings are not the best proxy of risk because they tend to be lagging indicators and have only a modest correlation to actual losses to the fund. In addition, linking CAMEL ratings to direct costs would create additional conflict regarding the ratings. CAMEL ratings are somewhat subjective supervisory tools, and extreme caution should be exercised in putting them to uses for which they were not designed. A more objective model involving the risk on an institutions' balance sheet and inherent in the complexity of their operations has more intuitive appeal.<sup>2</sup>

- ④ Comparable alternatives need to receive ample consideration. Some of the research on risk-based deposit insurance pricing notes that a Prompt Corrective Action (PCA) system based on a well-designed, entirely risk-based capital requirement is a comparable method of addressing the moral hazard and equity issues of deposit insurance. As noted in NCUA's October 10, 2003, response to the draft GAO report, an alternative that we believe merits careful consideration is the adoption of a PCA system based on risk-based net worth. NCUA believes this is a preferable way to provide incentives,

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<sup>2</sup> Federal Reserve Board Chairman Alan Greenspan's February 2003 testimony before the Senate Committee on Banking, Housing, and Urban Affairs indicates capital strength and overall examiner rating do not capture all the risk that institutions could create for the insurer. A robust risk-based premium system based on economic variables related to an institution's risk of failure, though admittedly technically difficult to design, is preferable.

impose discipline on the industry in this area, and align risk with cost. A PCA system where required net worth levels are tied to an institution's risk profile would provide for self-regulation and impose a higher cost (albeit indirect) on those institutions with high growth and/or riskier operations. This would also achieve the goal of linking the insurance fund's protection to the risk each institution poses, as credit union net worth provides for a cushion against losses to the NCUSIF.

Perhaps it is time the credit union industry gives in-depth consideration to these issues and the various options for pricing share insurance, while still seeking to preserve the underlying mutual nature of credit unions. Thus, using an approach similar to the FDIC's regarding their current deposit insurance reform proposal, NCUA plans to partner with credit union and academic organizations over the next few years to study and vet the advantages and disadvantages of the various share insurance pricing and funding alternatives. We will foster research, discussion, and debate on this issue to determine if there is merit to advocating that Congress change the way federal share insurance is priced, and what the details of such a change, if any, should be.

### **Insurance Fund Loss Estimation Methodology**

**Recommendation:** Study ways to refine the method of calculating NCUSIF's loss reserves.

**Response:** NCUA has had an ongoing dialogue with the FDIC on the issue of calculating reserves for insured institution losses. On December 9, 2003, NCUA met with representatives of the FDIC to discuss the recommendations made by their consultant to improve their reserving process. It would appear there is merit to tailoring FDIC's method for use by NCUA in establishing the NCUSIF's loss reserve level. The primary potential advantage of FDIC's method would be to provide NCUA with a better estimate of losses by basing the reserve calculation in part on the risk-profile of the credit unions subject to failure.

This modification to our current procedure may allow for an enhancement to an already reliable and successful process. It is important to note that the existing process has proven reasonable, has been found to be consistent with generally accepted accounting principles, and has never resulted in a materially under funded or over funded reserve account. Since reserving for losses is an accounting exercise in matching current revenues with expenses, the primary focus will be to ensure an overall equity level sufficient to cover the risks to the NCUSIF.

An adjustment to the reserving method to reflect the differences between insurance funds and the underlying insured institutions is also planned for 2004. Additionally, NCUA plans to conduct back-testing and make refinements to



parameters as warranted, and develop procedures for necessary data collection and implementation of the process. We believe the new method can be incorporated at minimal cost, and the sophistication of the new method will be commensurate with the materiality of the reserve fund.

Sincerely,

Dennis Dollar  
Chairman